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A Perspective on Western Small Businesses and Their Capital Requirements Speech

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A PERSPECTIVE ON WESTERN SMALL BUSINESSES

AND THEIR CAPITAL REQUIREMENTS

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INTRODUCTION

Presented at the annual meeting of WESTPO, 1980, a study directed by the WESTPO staff revealed that almost 70% of all employed persons in this region worked for small business. Compared with the national average of 56%, this one characteristic alone identifies our region as primarily dependent upon its small business economy.

WESTPO has also estimated total population impacts using a factor of 4.92 times the prime new energy jobs created. It follows then that at least 3 out of 5 new jobs supporting this expected in-migration of people will be involved in small business.

If these assumptions are valid, then it is also valid that, comparatively, the economic health of the WESTPO region can be measured by the economic health of its small business community.

Unfortunately, such a diagnosis of the health of our small business sector requires the use of national rather than regional statistics. One of the most visible symptons of an illness is the rate of bankruptcies.

A recent report of the National Small Business Association, dated September 21, 1981, reveals the following:

Court-filed bankruptcies from mid-1975 to mid-1979, did not vary more than 10% year to year, and averaged 31,000 per year. However, within a few months after the Federal Reserve Actions of October 1979 which boosted interest rates to the then-record levels, business bankruptcies began to climb dramatically. Totals reached an average of nearly 3,800 per month in the spring of 1980, climbing to a new plateau of about 4,000 per month by June, 1981. Thus, the business bankruptcy level increased 63.57% from the beginning of October, 1979 to the end of June, 1980.

These figures are very conservative for two reasons. First, the Dun & Bradstreet figures do not include finance, insurance, and real estate industries where small businesses predominate.

Second, they do not include business closures or "walkaways." These are businesses that just close their doors and terminate their business. They may owe creditors nothing, or, they may have substantial debts which are satisfied through attachments on bank accounts or foreclosing tax liens or mortgages, leaving few assets for general creditors to pursue. There appears to be no overall source of statistics on these "walkaways", but the Small Business Administration estimates that 400,000 to 450,000 businesses per year in an average year (1975-1979) go out of business for a variety of reasons. It would not be unreasonable then to estimate that there are approximately 14 business closures for every court-filed D&B-listed bankruptcy.

Assuming that total business closures are directly proportional to changes in the rate of bankruptcies, and further assuming the SBA "average" business closure is reasonable, the current rate of business closures should approximate 650,000 to 700,000 per year. Attached is a graph (Exhibit 1) comparing the prime rate, quoted from the Federal Reserve bulletin and the D&B Business Failure Rate, by quarter from 1978 through first quarter 1981. Note that although the prime rate is a more volatile curve, the sad fact is that the rate of business failures matches, all too painfully close, the prime rate

Another less visible symptom of an illness in the small business sector is its reducing contribution to Gross National Product. Since GNP is calculated by dividing the dollars of output by the numbers of bodies (not cost) of labor, and since small business is characteristically more labor-intensive than big business, its contribution to GNP is probably underestimated. Nevertheless, a contribution in 1972 of approximately 46% of the GNP has eroded to approximately 43% in 1980, with the difference, of course, being made up by the increasing contribution by the larger business sector. The continuing downward trend, however, is a strong suggestion that the illness is terminal!

Many contributing reasons can be identified such as over-regulation, government tax policy, etc. As a personal opinion, most of these government impediments would correct themselves if small business were to occupy its proper seat at the negotiating tables of government policy.

A third symptom of this illness is evident from a review of the few sources of capital available, particularly the lack of access to major pools of investment capital such as pension or profit-sharing funds.

Another perspective would be to compare the reactions of small businesses with those of multi-national corporations in the event of an emergency such as occurred in March, 1980, when credit controls were imposed by the Federal Reserve. Many small businesses experienced a cut-off in credit from their only source of capital, the local bank. The compounded effect of this was so crippling to small business that subsequent small business relief was required to prevent a disaster.

How multi-national corporations react is typified by the following quote from the Treasurer of a multi-national corporation at the "Conference on the Future of Financial Services Industry",sponsored by the American Bankers Assn., Washington, January 1981.

"All of us had our eyes opened last March with the imposition of credit controls, and they will come again, in my opinion."---"In the eyes of a corporate treasurer, however, they are probably among the most feared of all events, primarily because their form cannot be predicted in advance and they hit him where it hurts the most -- the final availability of money. So what does a corporation do---. The answer lies in having as many different sources to tap as possible:

(1) Credit lines with U.S. banks, preferably on a fee-paid committed basis.
(2) Credit lines with foreign banks in U.S. dollars and also in their own local currencies.
(3) Acceptance lines with foreign merchant banks to tap their equivalent to our commercial paper market.
(4) Bankers' acceptance facilities in the U.S. and discount lines abroad to liquify your receivables.
(5) Top commercial paper ratings and established acceptance for your paper in the marketplace.
(6) Acceptance of the corporate name in the Euro-Dollar bond market.
(7) Maintenance of at least an 'A' bond rating plus good liaison with the major rating agencies.
(8) Borrowing and warehousing long-term, fixed rate money when and if it is available on reasonable terms rather than when it is needed."

Compared with these eight sources of capital available to a multi-national corporation, small business has to look only to its local bank, friends, neighbors, or relatives, or in the event the small business has a short-term potential for rapid growth or a profile that would justify a public offering, then, and only then, are conventional venture capital funds available.

In summary, the patient, indeed, has a terminal illness. Unfortunately, because it has a weak voice with government as well as financial institutions, when it complains, the usual response is typified by the doctor who advises the patient, "Take two aspirins, get a good night's rest, call me in the morning, and that will be $20, please."

TRADITIONAL SOURCES OF CAPITAL: A Changing Scene.

The local full-service commercial bank has been the main source of commercial loans to business of all sizes in the community. In addition to its banking services, it provides an extremely valuable function as a financial advisor to its small business customers. The smaller the bank, the more direct and personal the relationship. From the newest commercial account using a short-term note with personal signature and personal assets as collateral, to the emerging company with an established rollover credit line of over a million dollars, the full-service bank continues to be the fundamental source of capital for small business in America.

Due to the 1980 so-called "Bank Deregulation Act," the American Bankers Association predicts that America's 14,500 banks will be concentrated through mergers and interstate banking to some 3,500 banks by 1985. It is axiomatic that "big banks make big loans and small banks make small loans." What happens to the local bank as it becomes a branch, operating from policies of the money center bank or holding company? Will the money center bank prime become the prime of the rural bank which in many cases makes commercial loans far below "New York Prime." The American Bankers Association further predicts the concentration of banking in the U.S. will make the system more efficient - but the small business community (which opposed branch banking in Colorado) asks,"For whom?"

THE U.S. SMALL BUSINESS ADMINISTRATION: A Changing Scene

The SBA, aside from minority loan programs and special-interest, politically motivated miscellaneous programs, has fundamentally responded to small business capital needs with direct lending and guaranteed bank loans. The SBA Administrator has just recommended the elimination of the direct loan program since its losses approached 44% of this $700 million annual program involving subsidized interest rates. The bank guarantee loan program, wherein the SBA guarantees 90% of the loan made by the bank, has been highly successful. However, recent suggestions by the Administrator of reducing the amount of guarantee, together with a request for comment of limiting the interest rate to no more than Prime, hints very strongly that the program is being intentionally made less attractive to the banking community. Some Washington observers consider this a strong signal for eliminating SBA as an independent agency.

Although most small businesses are not thrilled with SBA and its loan programs, it is ironic to note that the government has guaranteed loans to two companies, an automaker and a synfuels development company -for a total amount equal to more in just two loans then it does for all of its 14 million small business entrepreneurs.

PRIVATE INVESTORS

Except for rare circumstances, the typical private investor, when faced with a choice between investing in a listed stock versus a small business, has an easy choice to make. Purchase of a listed stock requires a 5-minute phone call to a broker whose commission is tolerable, the down-side risk on the security is minimal, and he can liquify his investment with another phone call. A small business investment, on the other hand, is usually 3 to 10 years; has almost no prospects for liquidity; the down-side risk can be catastrophic and he will often find himself a partner in the management. In both cases, any capital gains are treated exactly the same by the IRS.

Until there are federal tax incentives sufficient to divert capital away from the listed securities and other alternatives, this source of capital will remain a fairly insignificant source of capital for small business.

VENTURE CAPITAL

There are over 500 venture capital companies licensed by the Small Business Administration as small business investment corporations. The track record of companies receiving SBIC funds is 600% better than companies not receiving funds. The reason is simply that they are selected by an expert who is usually standing by to provide additional financing if needed and who also acts as a financial advisor, monitoring the company from a board of directors position.

Unfortunately, the availability of government funds for SBIC's has been curtailed and many of these venture capital firms are reorganizing in a manner to better attract private capital and shed the constraints imposed by government regulations. There has been a dramatic increase in the amount of venture capital available in the past year, much of it in the form of pure venture capital limited partnerships. We should anticipate seeing an abundance of this type of capital available in the inter-mountain region. If there is a negative in this area, it is simply that the number of companies with a sufficient track record, good management, and high growth potential, represent a small percentage of the total small business community.

PUBLIC OFFERINGS

New public stock offerings of companies with a net worth of $5 million or less secured approximately $800 million from such offerings in 1980. Much of this activity was fueled by venture capital companies which, by themselves, placed over a billion dollars in small growth companies in 1980. The public market for many small growth companies represented an opportunity to launch their companies using the cheapest source of funds, equity capital, from a public offering.

Recent publicity about abuses in the Penny Stock Market have, with the downturn in economy, dampened the enthusiasm for new offerings. Many knowledgeable persons in the Denver financial community agree there have been abuses, but also agree that they have been over-dramatized. They also agree that the Securities and Exchange Commission is fully justifed in further relaxing the regulations which have been an impediment to small business for access to the public market.

RECOMMENDATIONS

Throughout the WESTPO region, there are many pockets of high-technology growth industries. Even though they represent a small percentage of the number of small businesses in the region, they represent the cutting edge of the creative strength of America and should be counted on to provide a basic source of employment in the post-energy boom era.

Venture capital and its access to institutional funds, not otherwise available to small business, should be encouraged. The "invisible hand" of the marketplace is already at work successfully in this area.

Access to the public market should be protected and the abuses in public offerings should be controlled by enforcement mechanisms rather than new constraining regulations.

Attached as Exhibit 2 is a profile of a high-technology growth company from product conception to maturity. The most critical need for capital occurs in the first two to five years of research and development and startup costs. "Seed money" is generally only available from personal investment with some later help through commercial bank loans with personal guarantees.

Recommendation No. 1. Design tax incentives to encourage the private sector to develop innovation centers with access to "Seed capital" pools, supported by management assistance.

Recommendation No. 2 Encourage state deregulation, patterned after the Federal Regulatory Flexibility Act.

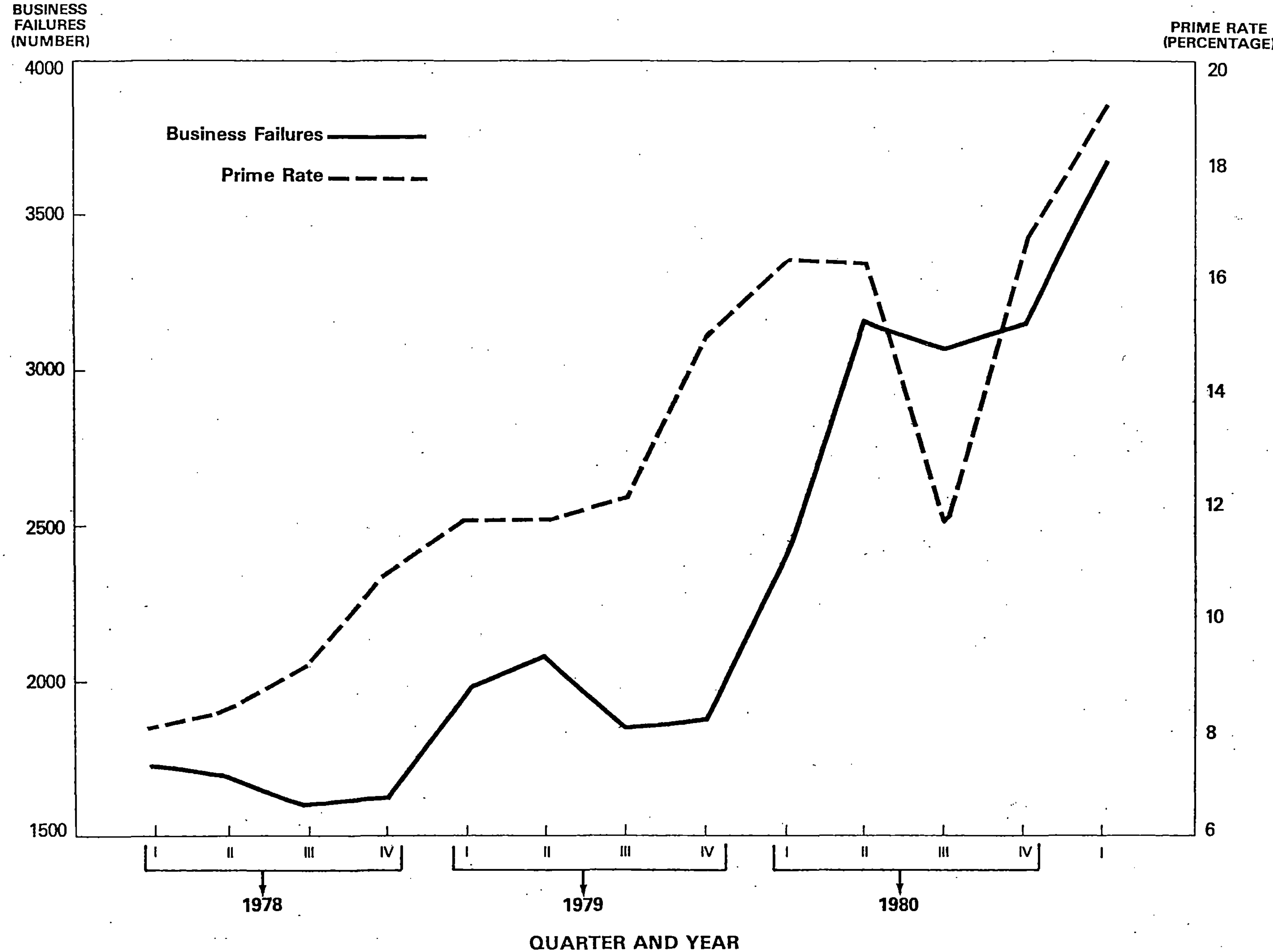
Recommendation No. 3. Restrict the use of Industrial Development Bonds and preserve their availability through umbrella pooling as the only long-term, low-cost source of capital now available for small businesses and small governments.

Recommendation No. 4. Encourage the development of business development companies (B.D.C.'s) involving participation by the banking community.

Recommendation No. 5. Explore the incentives to encourage voluntary energy company participation in a venture and seed capital long-term severance fund.

Recommendation No. 6 Avoid the use of "aspirin" type measures which only mask the illness, but insist upon cures which do not require the continous invasion of public funds.

BUSINESS FAILURES AND PRIME RATE



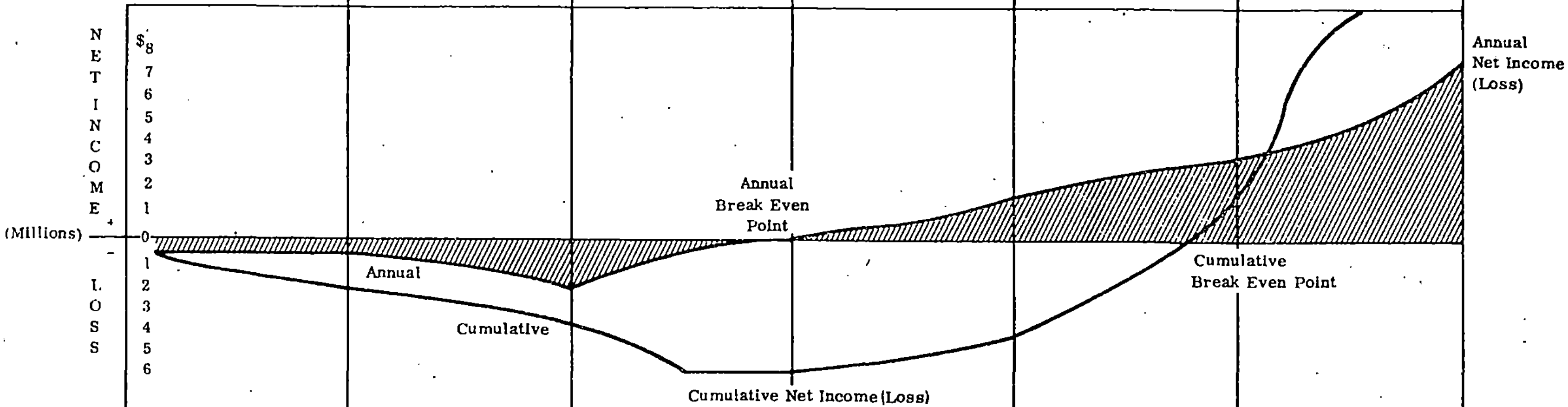
SOURCES: FEDERAL RESERVE BULLETIN, DUN & BRADSTREET

Exhibit #1

EXHIBIT #2

LIFE CYCLE OF A NEW ENTERPRISE
MODEL OF A GROWING AND SUCCESSFUL COMPANY
1975-1976 FINANCIAL MARKET CONDITIONS

Phase:	0	1	2	3	4	5
Activity Level:	R&D	Start-Up	Early Growth	Accelerating Growth	Sustaining Growth	Maturity
Revenues in Millions	-None-	Up to $2.0	$2 - 10	$10-25	$25-40	$40 and up



	0	1	2	3	4	5
I Company Characteristics:						
Capitalization	$5,000-1,000,000	$500,000-2,500,000	$2 million - 6 million	$6 million - 15,000	$15 million - 30 million	$30 million +
Length of Phase (Years)	1-5	1-3	2-3	3-4	2-5	-
Management and Organization	Founder; No Organization	Founder & Associates; Very loose organization	Founder or Professional Manager; Emerging Formal Organization	Founder or Professional Manager; Formal Organization	Professional Managers; Complex Organization	Multi-layered Complex Management Organization
"Equity" Financings						
Number	2-3	1-3	2-3	1	1-2	Ongoing
Average Size (Nature)	$100,000 (private)	$750,000 (private)	$1,500,000 (private)	$7,500,000 (public or senior private)	$15,000,000 (Insurance Co. and other long-term capital).	(Various)

II Applicable Govt. Regulations
- Tax Rate
- Depreciation Allowance
- Sub-Chapter "S"
- IRS: Rule 1244
- SEC: Rule 144
- SEC: Rule 146
- Regulation "A"
- SEC: 1933 Act

III Principal Financing Sources

Private
- Personal Investment
- Individual Investment
- Investment Firms (SBIC's etc.)
- Commercial Bank - Personal
- Commercial Bank - Corporate
- Insurance Companies

Public Financing